Internal Revenue Service

memorandum

CC:TL-R-4515-86
Br4:JRDomike

date: 26 JUN 1986

to: District Counsel, [redacted] CC:PIT
Attn: [redacted]

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This responds to your memorandum dated April 10, 1986 requesting technical advice in this case.

ISSUES

1. Whether the payments made by the Urban Renewal Authority of Pittsburgh, from funds including federal funds authorized under Title I of the Housing Act of 1949, for rehabilitating the historic facade of the taxpayer-[redacted] are includible in gross income. 0061.40-00; 0061.05-05; 0061.14-04.

2. If so, when are the payments, made during three calendar years (taxable years), to be included? 0451.01-00.

3. Whether the payments are included in the taxpayer's basis in the building. 1012.02-00.

4. Whether the taxpayer may claim depreciation deductions and investment tax credit with respect to the facade improvement. 0167.00-00; 0167.27-00; 0167.28-00; 0191.00-00; 0265.01-00; 0038.02-00; 0048.13-00; 0048.01-00.

CONCLUSIONS

On May 23, 1986, Joan Domike of our office communicated these conclusions to trial attorney [redacted] in your office:

1. The payments are includible in the taxpayer's gross income.

2. The payments are includible in income for the taxable year of the taxpayer in which they are made. Alternatively, the taxpayer received taxable income when he first had the use and enjoyment of the improvements.

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3. To the extent the taxpayer includes the payments in gross income, he should be entitled to increase his basis in the property.

However, if the grant is not includible in gross income, no increase in basis should be allowed.

4. Assuming the grant is includible in the taxpayer's income, he would receive a basis in the amount and a corresponding deduction for depreciation and investment tax credit for the rental portion of the property.

If the grant is determined to be excludable, he would not be entitled to increase his basis. Therefore, no deduction for depreciation or investment tax credit could be available.

As an additional alternative position: if the grant is excludable but it is also determined that basis may be increased, the taxpayer should be precluded from claiming depreciation and investment tax credit.

These conclusions have been coordination with the Individual Tax Division.

FACTS

The facts, as stated in your memorandum, are as follows:

[redacted] purchased the structure at [redacted] from the Urban Redevelopment Authority of [redacted] (hereinafter URA) on [redacted] for $[redacted]. The property is located in the [redacted] area of [redacted], an area which was the subject of an urban renewal project. The [redacted] project began in the [redacted]'s.

[redacted] is designated as a national historic area. It is claimed that the structure at [redacted] is a certified historic structure. When [redacted] purchased the structure at [redacted], he entered into another agreement with URA whereby he gave the URA a "right to enter" easement to allow the URA to restore the facade of the building in a manner which was consistent with the historic classification of the district. In addition to the easement, [redacted] convenanted to maintain the facade in the restored condition and not to alter the facade. Finally, [redacted] convenanted to rehabilitate and maintain the interior of the historical structure in accordance with "Property Rehabilitation Standards" of the [redacted] (herein referred to as the "rehabilitation agreement"). This rehabilitation agreement served as the basis

for the facade grant. [redacted] was aware that the facade grant was part of the redevelopment program when he purchased the property.

Pursuant to the terms of the rehabilitation agreement, $[redacted] was expended by the URA on the facade at [redacted]. The URA contracted the restoration to a contractor and made periodic payments directly to the contractor. However, the taxpayer's attorney represents that all checks payable to the contractor had to be signed by both the URA and [redacted], and other individuals indicated that [redacted] had to authorize release of the funds to the contractors. Further verification of this aspect is in progress. The payments were made by the URA to the contractor as follows:

Date	Amount
[redacted]	$[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
TOTAL	$[redacted]

The payments were made as work was completed. The $[redacted] constitutes the facade grant, the taxability of which is at issue.

Additionally, as part of the package, [redacted] was given a low-interest loan of $[redacted] to assist him in completing the interior rehabilitation of the building. The interior rehabilitation began in [redacted] and was completed in [redacted]. Loan proceeds were not paid to the contractor for the work on the interior of the building until [redacted] did not have to begin repayment of the loan until [redacted]. Finance charges did not accrue on the loan until [redacted]. The loan was made by the URA under the Home Improvement Loan Program.

The structure at [redacted] has been divided into [redacted] apartments. [redacted] lives in one unit while he rents out the other [redacted]. They were rented to tenants in the fall of [redacted].

The facade grant was paid from the [redacted] fund. As indicated previously, [redacted] is a certified historic area. The area is relatively low-income. Since individuals were unable or unwilling to rehabilitate the large buildings in a historically consistent manner, the grants were given as a part of the redevelopment project to ensure that the properties would be restored in a manner consistent with historic certification. To participate in the program, an individual had to purchase property in the area from the URA and had to agree to remodel the interior. There were no restrictions as to who could purchase the property; purchasers did not have to establish that they were "low-income." Additionally, properties could be purchased with the intent of owning rental property, as two-thirds of the property owned by [redacted] was held. Absentee landlords, developers and non-profit organizations were allowed to participate in the program. Finally, the amount of the grant was not determined by reference to the financial needs of the recipient, but was determined by the work that needed to be done on the facade. In no event did the individual purchaser of property have to contribute to the cost of the facade rehabilitation.

The funds for the [redacted] program were two-thirds federal and one-third local. The federal funds were originally authorized under Title I of the Housing Act of 1949, 42 U.S.C. § 1450 et seq. and, after January 1, 1985, were authorized under 42 U.S.C. § 5305(a)(10) (see also § 5316). Since section 5305(a)(10) simply allows the continued funding of Title I projects already initiated, the substantive provisions of Title I are controlling. [redacted], attorney for the URA, indicates that the facade programs were paid out of federal Title I funds.

[redacted] did not include any of the facade grant in his income, but did include the amount in his basis for purposes of depreciation and the investment tax credit. A statutory notice of deficiency was issued, and it included the entire grant in [redacted]'s income for [redacted], while it reduced his claimed depreciation deductions and investment tax credits to remove the grant portion from his basis. This inconsistent position was taken to protect the government's interest if the Court should rule that the grant is not properly includible in [redacted]'s income.

[redacted], controller for the URA, indicated that the amounts of the grants are determined in advance but are not paid out all at once. Upon further investigation, Counsel was informed orally that no monies were transferred for [redacted]'s benefit until [redacted], so a second notice was issued to include the $[redacted] in [redacted]'s income for [redacted]. The notice was issued

to keep the statute open while this matter is resolved. Adjustments may now be made to reflect when the income was received, if it is includible, as all years remain open..

You orally informed us that the petitioner is a cash-basis taxpayer.

PROPOSED POSITIONS

Taxpayer's Position

It is taxpayer's position that the grant to [redacted] was made under a legislatively provided social benefit program for the promotion of general welfare and thus should not be included in his gross income. He believes that the facts in his case are similar to Rev. Rul.76-395, 1976-2 C.B. 16, and Rev. Rul. 76-144, 1976-1 C.B. 17. This belief is based on the underlying purpose surrounding the program whereby [redacted] obtained the funds in question.

The taxpayer points out the stated objectives of the [redacted] are to--

a) assist physical, economic and social development of the community;
b) provide for stablized population and plan for the optimal growth of the area;
c) provide land for new housing and needed community facilities, project improvements and open space;
d) make provision for a substantial number of housing units of low and moderate cost on land to be disposed of for residential purposes;
e) encourage a sense of community identity, safety and civic pride;
f) preserve, where feasible, properties of historic and architectural value;
g) eliminate incompatable land uses;
h) eliminate structurally substandard buildings;
i) eliminate physical and environmental blight; and
j) eliminate impediments to land disposition and development.

It is his position that while one of the goals is to preserve historic property where feasible, the majority of the goals seek to provide social benefit programs for the promotion of the general welfare of the community. Accordingly, he does not believe that the payments should be included in his gross income.

District Counsel's Position

You recommend that the grant be included in [redacted]'s income. You further recommend that to the extent the federal grant is includible in income, his basis in the property should be increased. The growth of basis should be directly related to the timing of the payments for the construction on the facade.

DISCUSSION

Issue 1

Except as otherwise defined, "gross income" means "all income from whatever source derived". I.R.C. § 61(a). The grant at issue in this case is not otherwise defined in the Code, nor specifically included in gross income (see sections 61(a)(1)-(15) and Part II (section 71 et seq.)) or specifically excluded in Part III (section 101 et seq.).

In Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), 1955-1 C.B. 207, the Supreme Court defined "gross income", as used in the Internal Revenue Code, to include all accessions to wealth that are clearly realized and over which the taxpayer has complete dominion. The Court relied in part on Helvering v. Bruun, 309 U.S. 461 (1940), 1940-1 C.B. 112. In Bruun, the fortuitous gain accruing to a lessor by reason of the forfeiture of a lessee's improvements on the rental property was held to be a taxable windfall.

Similarly, payments made by the government to reimburse a taxpayer for expenditures to construct or purchase property, or to make repairs, has been held to be income to the recipient. See Baboquivari Cattle Co. v. Commissioner, 135 F.2d 114 (9th Cir. 1943), aff'g 47 BTA 129 (1942); Lykes Bros. Steamship Co. v. Commissioner, 126 F.2d 725 (5th Cir. 1942); Dubay v. Commissioner, T.C.M. 1979-418; Harding v. Commissioner, T.C.M. 1970-179; Driscoll v. Commissioner, 3 T.C.M. (CCH) 73.

However, as is discussed in your memorandum, there may be ground for exclusion of the grant from income. The Internal Revenue Service has consistently held that payments made under legislatively provided social benefit programs for the promotion of general welfare are not includible in the recipients' gross incomes. See, e.g., Rev. Rul. 78-170, 1978-1 C.B. 24 (Ohio payments to reduce energy costs); Rev. Rul. 78-80, 1978-1 C.B. 22 (foster grandparents stipend); Rev. Rul. 77-77, 1977-1 C.B. 11 (Indian Financing Act); Rev. Rul. 76-144, 1976-1 C.B. 17 (Disaster Relief Act); Rev. Rul. 76-63, 1976-1 C.B. 14 (unemployment benefits); Rev. Rul. 76-75, 1976-1 C.B. 14 (interest reduction - National Housing Act); Rev. Rul. 76-229, 1976-1 C.B. 19 (trade readjustment allowance); Rev. Rul.

76-373, 1976-2 C.B. 16 (relocation - Housing and Community Development Act); Rev. Rul. 76-395, 1976-2 C.B. 16 (home rehabilitation - Housing and Community Act); Rev. Rul. 75-246, 1975-1 C.B. 24 (C.E.T.A.); Rev. Rul. 75-271, 1975-2 C.B. 23 (mortgage assistance - National Housing Act); Rev. Rul. 74-153, 1974-1 C.B. 20 (payment to adoptive parents); Rev. Rul. 74-74, 1974-1 C.B. 18 (crime victims' awards); Rev. Rul. 74-205, 1974-1 C.B. 21 (discussed under Issue 3); Rev. Rul. 73-87, 1973-1 C.B. 39 (Economic Opportunity Act); Rev. Rul. 72-340, 1972-2 C.B. 31 (stipends to probationers); Rev. Rul. 71-425, 1971-2 C.B. 76 (payments - work training program); Rev. Rul. 68-380, 1968-2 C.B. 446, and Rev. Rul. 63-136, 1963-2 C.B. 19 (manpower retraining); Rev. Rul. 57-102, 1957-1 C.B. 26 (Pennsylvania payments to the blind). This administrative rule was first enunciated in Rev. Rul. 57-102. See generally United States v. Kaiser, 363 U.S. 299, 305-325 (1960) (concurring opinion of Mr. Justice Frankfurter).

The Revenue Rulings which find that payments are in the nature of general welfare and are not includible in the recipients' incomes look to the purpose of the act under which the payments were made, and also look to the nature of the payments and the individual recipients. You note that the common thread in the Revenue Rulings that exclude the grants from income is a determination that the grants were based upon some basic need of the recipients. Thus, the Service determined that payments made by the State of Alaska to long-term residents, which payments were based upon longevity rather than the recipient's financial status, health, educational background or employment status, were not based on general welfare and were includible in the recipients' incomes. Rev. Rul. 76-131, 1976-1 C.B. 16. In another case, the Service determined that relocation payments paid by a landlord to displaced tenants pursuant to a municipal ordinance were not payments in the general welfare because they were not made by a governmental entity and, moreover, they were not based on need of the recipients and were not substitutes for payments made by a governmental entity. Rev. Rul. 82-106, 1982-1 C.B. 16.

The taxpayer seeks to have the $[redacted] facade grant excluded from his income upon the theory that the grant was made as part of a social benefit program for the promotion of the general welfare of the community. This argument is based upon the goals of the [redacted] as a whole, as well as the goal of historic preservation. You note that, in at least one instance, the Service has found that nonreimbursable grants made to Indians and to Indian tribes for the purpose of stimulating Indian entrepreneurship and employment on and near reservations were payments made under a social benefit program for the promotion of the general welfare and said amounts were not includible in income. Rev. Rul. 77-77, supra. The payments

to the Indians were arguably given based primarily upon the need of the community and not that of any particular individual. Therefore, there may be support for the interpretation that the giving of a grant based upon the need of the community of [redacted] is excludable from income as to the individual recipient who directly benefited from the grant because the overall community was benefited. This, however, appears to be extending the "general welfare" exclusion beyond the limits normally recognized by the Service.

All government subsidies or grants are not excludable from income. See, e.g., Rev. Rul. 60-66, 1960-1 C.B. 22. In Rev. Rul. 76-6, 1976-1 C.B. 176, modified and superseded by Rev. Rul 84-67, 1984-1 C.B. 28, the Service found that reimbursements under the forestry incentives program were includible in the recipient's income. The Revenue Ruling cited Baboquivari Cattle Co. v. Commissioner, 135 F.2d 114 (9th Cir. 1943), as support for the Ruling. In Baboquivari Cattle, the Ninth Circuit held that payments made to a farmer under the Soil Conservation and Domestic Allotment Act are includible in his income even if it is accepted as true that the primary purpose of the legislation was to promote the general good and not the interest of an individual. The Court found significant that the "mainspring of the activities of the individual recipient [was] self-interest." 135 F.2d 116. Similarly, the motivation of [redacted] in participating in the [redacted] by purchasing the property can be viewed as activated by self-interest. However, due to the structure of the government reimbursement in Baboquivari Cattle, the monies received by the individual rancher in that case were unrestricted and could be used in any manner whereas, in the present case, the monies were never received outright by [redacted] and were expended directly for the historic rehabilitation of the facade. To the extent that the Ninth Circuit based its ruling on the lack of restrictions on the monies, the case may be inappropriate to the present situation.

The major argument against finding that the facade grants constituted payments made for the general welfare is that the grants were not restricted to underprivileged individuals who purchased buildings to use as residences, but could be given to structures purchased for use in the production of income by developers and absentee landlords. It is our policy not to treat benefits that could go to businesses as general welfare benefits. See G.C.M. 37920, Federal Disaster Assistance Administration (April 5, 1979), copy attached.

The analysis in Rev. Rul. 80-330, 1980-2 C.B. 29, is particularly appropriate. The ruling holds that payments received by an individual under section 101 of the National Historic Preservation Act of 1966 are includible in his gross income. Rev. Rul. 80-330 states:

> The payments in this case are distinguished from welfare program payments such as those involved in Rev. Rul. 76-395 and Rev. Rul. 76-144. The ultimate recipients of the payments in this case can be governmental units and other organizations exempt from federal income taxation and they can be taxpayers, including individuals, corporations, and unincorporated entities. Payments made to individuals can be made with respect to the individual's personal residence, and they can be made with respect to property used in the individual's trade or business or for the production of income. Thus, the payments are not based on an individual recipient's personal financial status, health, educational background, or employment status, nor are they intended to improve the living conditions of low-income homeowners. Rather, the purpose of the payment is to preserve historically significant structures. Thus, the payments are not made under a social benefit program for the promotion of general welfare. [1980-2 C.B. 29.]

The facade grant is not specifically excluded in the Internal Revenue Code, and no exclusion could be found for it under the provisions which authorized the funding. Compare Rev. Rul. 82-195, 1982-2 C.B. 34, obsoleting Rev. Rul. 80-330, 1980-2 C.B. 29 (payments under National Historic Preservation Act of 1966 received after December 12, 1980, not includible in income because specifically excluded by amendment to the granting Act). The failure to specifically exclude the grant from income under the Title I funding provisions is significant and supports our opinion that the monies are includible in [redacted]'s income. Harding, supra, and Baboquivari Cattle, 47 B.T.A. at 136.

Therefore, we concur in your position that the grant is includible in the taxpayer's gross income. In short, we agree that because the grants here are not based on the recipients' needs nor were designed to benefit the recipients themselves as opposed to the public at large, the general welfare exclusion should not be applied.

Issue 2

Assuming the grant is not excludable under the general welfare doctrine, there are three different potential dates the grant could be includible in the taxpayer's gross income. The first would be the original date of the grant. The second would be when each phase of the work is completed. The last would be those dates when the City paid the contractor.

Section 1.451-1 of the Income Tax Regulations provides, that gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received.

Section 1.451-2 of the regulations provides, in part, that income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

In the instant case, after the City and the taxpayer had signed the covenant and grant documents, the City dealt directly with the various contractors in carrying out the rehabilitation project. Although the taxpayer was a signatory on those checks issued by the City to the contractors, those funds were never at the taxpayer's disposal. Because the taxpayer had no control over the timing of the funds disbursed by the City and because his receipt of the improvements was subject to substantial limitations, the taxpayer was not in actual or constructive receipt of income on the date he signed the grant. As the taxpayer used a cash receipts and disbursements method of accounting, we find it inappropriate to include the grant in the taxpayer's income on the date the covenant and grant documents were signed.

Elimination of the grant date as a possible date of inclusion leaves the choice of either the dates the City made the payments or the dates the taxpayer received the benefit of the contractors' efforts. The primary contract here runs between the City and the contractor with the taxpayer being a third-party beneficiary of that contract. As such, the most accurate reflection of the time the taxpayer received the benefit of the primary contract would be the earlier of the dates the taxpayer had the use and enjoyment of the improvements or the dates payments were made.

In the situation where there was a gap between the date the taxpayer had use of the improvements and the date the City paid the contractor, we would find income on the date of unrestricted enjoyment of the improvements. Assuming the taxpayer generally benefited from the improvements before the City paid for them,

and ignoring any claims which the contractors might have had on the property, there would technically be income on the earlier date. However, due to the difficulties inherent in determining the value of the improvements on an ongoing daily basis, we believe the best administrative solution would be to tax the grant on the date the City paid the contractors. You can make an alternative argument to the Tax Court that income is received on the date of unrestricted enjoyment of the improvements; and if the relevant facts have not been established, you could argue that the petitioner has not shown that such income would be less than that determined in the statutory notice.

Another reason for taxing the grant as the payments were made is that the checks payable to the contractor had to be signed by both the URA and the petitioner, and the petitioner had to authorize release of the funds to the contractors. These facts indicate that the petitioner had sufficient control over the funds to treat him as having received the payments under the grant. An alternative position would be that petitioner received the value of the improvements, because the measure of the income is the economic benefit conferred. The evidence of this value in the notice of deficiency is the amount of income determined. The petitioner has the burden to prove a lesser amount.

Issue 3

To the extent the taxpayer includes the amount of the grant in income, he should be entitled to increase his basis in the property. Section 1.1012-1(a) of the Income Tax Regulations provides, in part, "The basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property." The taxpayer here incurs a cost with respect to the grant when he includes it in income. An analogous situation would be where the taxpayer received a taxable no-strings-attached payment and then separately paid for the improvements. Thus, the taxpayer should be entitled to increase his basis in the property by the amount of his associated cost in it, which would by the amount of the payments included in his gross income. The growth of the basis should be directly related to the time of the payments.

Conversely, if for some reason this grant is not found by the court to be includible in the taxpayer's income, no increase in basis should be allowed. Under the general basis principle discussed previously, if the grant were excludable from income the taxpayer would have no associated cost in the improvements, and therefore there should not be any adjustment in basis.

However, upon at least one occasion the Service allowed an increase in basis where the associated grant was not includible in income. In Rev. Rul. 74-205, 1974-1 C.B. 20, the Service held that replacement housing payments made to persons displaced by Federal programs were not includible in gross income under the general welfare doctrine. Without any explanation the revenue ruling further holds that the recipient be allowed to increase his basis in the new property by the amount of the payment.

Rev. Rul. 74-205 was based on G.C.M. 34957, [redacted] (July 21, 1972). The G.C.M. (copy attached) offers a more complete explanation of the Service's rationale for allowing an increase in basis. In the G.C.M. it is mentioned that the recipients resided in blighted areas and that the program was directed towards assisting moderate and low income recipients. The G.C.M. compared the program to its successor program and to another similar program in which housing replacement payments were statutorily excluded from income. It is stated in the G.C.M. that the absence of specific language excluding the subject program payment from income was a legislative oversight. In view of those circumstances, G.C.M. 34957 reasoned that Congress also intended that the recipients be allowed to increase their basis by the amount of the payments so they would receive a true tax exemption of the payments and not simply a tax deferment. In other words, the G.C.M. applied the general welfare doctrine not only to exclude the payments from income but also extended it to allow an increase in the basis of the property.

We believe the facts in the instant case are distinguishable from those in Rev. Rul. 74-205. The grants in the present case can be made not only to individuals, but to businesses and other organizations as well. The ruling did not consider either the income or the basis question in a business context. In fact, the general welfare exclusion has never been applied in a business context. (See G.C.M. 37920, supra, at 14.) Furthermore, the primary focus of the instant program is to benefit the general public by restoring historic stuctures, not to benefit the recipients of the grants; whereas, in Rev. Rul. 74-205 the primary beneficiaries of those payments were clearly intended to be the displaced homeowners. Finally, there has been no suggestion, as there was in G.C.M. 34957, that the absence of specific statutory language excluding the payments from income, was the result of legislative oversight. For those reasons we do not believe the theory for allowing an increase in basis stated in G.C.M. 34957 should be extended to the present case.

Support for our position can be found in Wolfers v. Commissioner, 69 T.C. 975 (1978), where a business was denied an

increase in basis on property purchased with tax-exempt income received under one of the same programs analyzed in G.C.M. 34957. In reaching its decision, the Tax Court in Wolfers relied on two Supreme Court cases which denied a basis allocation attributable to the receipt of tax-exempt property. See Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943); United States v. Chicago Burlington & Quincy RR Co., 412 U.S. 401 (1973).) The court in Wolfers stated that "The fact an item of receipts is tax exempt by no means guarantees the taxpayer a basis in any item purchased with such receipts." 69 T.C. 988. The Tax Court went on to undermine the basis holding of Rev. Rul. 74-205, generally stating that its questionable result provided taxpayers with an unintended windfall.

We have located no authority which relies on our basis holding in Rev. Rul. 74-205. That is an indication to us that its result should be given limited application. In fact, G.C.M. 34957 itself states--

> We are not proposing to hold that any time the Service rules that a particular payment made by a governmental unit to a taxpayer to aid him in purchasing an asset is tax free, said payment should not reduce the basis of the asset. We are only reaching that conclusion under the particular facts and legislation involved here. The government in enacting the subject legislation has displayed an altruistic desire to improve the welfare of slum dwellers to further implement the national goal of providing a "decent home and a suitable living environment for every American family." The primary purpose is to benefit the individual. This is quite different from the motives behind tax benefits or grants to large commercial corporations such as steamship companies or railroads. In those cases the payments are intended to benefit primarily the public. [G.C.M. 34957 at 11.]

In a case such as this, where the payments can go to businesses and where the primary purpose is to benefit the public and not the recipient, the basis holding in Rev. Rul. 74-205 should not be applied. For these reasons, it follows that if the grant is found to be excludable by the court, no increase in basis should be allowed.

Issue 4

Assuming the grant is includible in the taxpayer's income, he would receive a basis in the amount of the grant and a corresponding depreciation deduction and investment tax credit */ for the rental portion of the property. If for some reason the grant was determined to be excludable from the taxpayer's income, as previously discussed, he would not be entitled to increase his basis. In that instance, no depreciation deduction or investment tax credit could be taken on an asset having a zero basis. We have also considered whether the taxpayer would be entitled to a depreciation deduction and investment tax credit where the grant was excludable from income and for some reason he was allowed to increase his basis. Even in that unlikely event, under specific statutory authority and the general rule against double tax benefits, we believe the taxpayer would not be entitled to any deductions or tax credits attributable to tax-exempt income.

Under section 265(1) of the Code, no deduction shall be allowed for any amount otherwise allowable as a deduction or allowable under section 212 which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from income tax.

Thus, there is specific statutory authority for denying a depreciation deduction in the present case. Furthermore, the Service has consistently maintained that deductions should not be allowed with respect to tax-exempt income because the taxpayer would otherwise receive a double tax benefit. For example, in Rev. Rul. 76-144, 1976-1 C.B. 17, no losses or expenses were allowed with respect to disaster relief payments that were excludable under the general welfare doctrine. An elaborate discussion of the interplay between deductions and tax-exempt income can be found in G.C.M. 34506, Assistance Payments Under Sections 235 and 236 of the National Housing Act (May 26, 1971), dealing with mortgage assistance payments.

Although an investment tax credit is not a "deduction" in the true sense of the term, we believe the same principle against providing a double tax benefit should be applied with respect to the credit here.

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*/ As these have been disallowed in the notice of deficiency the petitioner must prove entitlement.

In conclusion, it should be noted that our position on this issue is consistent with G.C.M. 34957, which states, "Were we presently dealing with a depreciation deduction, consistent with G.C.M. 34506, we could deny the deduction....[A]llowing such a deduction would give the taxpayer a double benefit of the exemption of the payment and the deduction of the depreciation allowance." G.C.M. 34957 at 15. Accordingly, based on section 265(1) of the Code and the clear and consistent position of the Service, the taxpayer in this case should be precluded from claiming depreciation and an investment tax credit in the event the grant is excluded from his income but his basis in the property was nevertheless permitted to be increased.

If you have any questions, please contact Joan Domike, room 4043, FTS 566-3345.

ROBERT P. RUWE
Director

By: Henry Salamy
HENRY G. SALAMY
Chief, Branch No. 4
Tax Litigation Division

Attachments:
GCM 34506
GCM 34957
GCM 37920

Note: These GCM's are availabe to the public. (They are redacted to remove taxpayer information and available in the IRS Freedom of Information reading rooms.)

JRDomike:sr:6/18/86

Internal Revenue Service
memorandum

date: JUN 26 1986

to: Director, Tax Litigation Division CC:TL

from: Director, Individual Tax Division CC:IND

subject: [redacted]

This is in response to your request for our views on the following four issues set forth in your proposed technical advice memorandum to District Counsel:

1. Whether the payments made by the Urban Renewal Authority of [redacted] (the "City"), from funds including federal funds authorized under Title I of the Housing Act of 1949, for rehabilitating the historic facade of the taxpayer's building (containing his personal residence and [redacted] rental apartments) are includible in his gross income?

2. If so, when are the payments, made during three calendar years, to be included?

3. Whether the payments are included in the taxpayer's basis in the building?

4. Whether the taxpayer may claim depreciation deductions with respect to the facade improvement? (Previously, this issue contained a question on the allowance of an investment tax credit. We have been informed that the taxpayer subsequently conceded his entitlement to the credit.)

ISSUE 1

We concur with District Counsel's position that the grant is includible in the taxpayer's gross income. We agree that because the grants here are not based on the recipients' needs nor designed to benefit the recipients themselves, as opposed to the public at large, the general welfare exclusion should not be applied. We would point out, however, that the real item of income the taxpayer receives is the value of the improvements to his property.

Director, Tax Litigation Division

ISSUE 2

Assuming the grant is includible in the taxpayer's gross income and that he uses the cash receipts and disbursements method of accounting, we believe the correct time of inclusion would be the earlier of the dates the taxpayer had the beneficial enjoyment of the improvements or the dates the payments were made to the contractor. In order to have the beneficial enjoyment of the improvements, the taxpayer's use would have to be free of any direct claims or liens the contractor had on the improvements prior to payment.

We find it inappropriate to include the grant in the taxpayer's income on the date the covenant and grant documents were signed. Because the taxpayer had no control over the timing of the funds disbursed by the City and because his receipt of the improvements was subject to substantial limitations, the taxpayer was not in actual or constructive receipt of income on the date he signed the grant.

ISSUE 3

To the extent the taxpayer includes the amount of the grant in income, he should be entitled to increase his basis in the property because he will have an associated cost in the property. However, if the grant were found excludable by the court under the general welfare doctrine, we believe the Service would be precluded from denying an increase in basis pursuant to our position in Revenue Ruling 74-205, 1974-1 C.B. 20. Under the theory that a true tax exemption rather than a tax deferment was intended by the grant program, if the Service lost on its argument that the grant should not come within the general welfare exclusion, the same argument for denying an increase in basis would not prevail.

ISSUE 4

Assuming the grant is includible in the taxpayer's income, he would receive a basis in the amount of the grant and a corresponding depreciation deduction on the rental portion of his property. If for some reason the grant was determined to be excludable from income, the taxpayer would nevertheless be precluded from taking a depreciation deduction pursuant to section 265(1) of the Code. That section denies any deduction allocable to tax-exempt income. Thus, if the grant was determined to be tax-exempt, no corresponding deduction would be allowed.